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ABSTRACT

Published monthly during the school year, the newsletter disseminates ideas and suggestions concerning innovations and problem solutions for secondary social sciences. This issue focuses on teaching economic concepts in the classroom. The information is intended to help teachers deal knowledgeably with topics that crop up in classes such as history, geography, current affairs, and social studies in general. The economic concepts dealt with are profit, prices and price-fixing, inflation, marginal utility, and indifference analysis. Each concept is defined and illustrated, and varying viewpoints are explained. (KSM)

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you, too

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ECONOMICS IN THE CLASSROOM

The present issue of you, too is devoted to a few simple economic concepts. Economics ought to be continuously part of the social science curriculum, not relegated to a special technical course (although the latter should not be excluded from the curriculum offerings). The following notes, then, are intended to help all teachers to deal knowledgeably and commonsensibly with some topics that crop up (or ought to crop up!) in classes in history, geography, current affairs, and social studies in general.

Readers are invited to comment on these notes, and to submit suggestions for further notes or explanations.

TEACHING ABOUT PROFIT

Surveys of high school and college students regularly reveal that a large proportion of young persons have little or no understanding of the nature and role of profit in the market economy. Many seem to regard profit in antiquated Marxist terms as surplus value coming from the bleeding lips of the starving proletariat; others see it as an unnecessary factor in the production-distribution process. It is, surely, part of our business as social science teachers to remedy this absurd situation.

Part of the trouble is that one-third of the American economy runs without reference to profit or loss, and teachers in tax-supported institutions are in the sector that is indifferent to profit. So are the police, the law-courts, elected officials, civil servants, and the armed services. For all these, profit or loss bears little or no direct relationship to their work, and the indirect relationship (taxes, after all, depend on the state of the market economy, and the state of the market economy is largely governed by calculations of profit and loss) often passes unnoticed. Actually, an unsolved problem of the public sector of the economy is this: How can one judge if a government operation is economically efficient, when the factors of competition, profit and loss are absent? The leaders of the Soviet Union have been exercised by this puzzle for several decades.

This, however, is beside the point. The immediate question is: What shall we teach about profit? Economists have disagreed about the precise nature of profit, so we cannot and should not offer one simple and dogmatic explanation. In general, we can agree that profit is the surplus of income over outgo, and that, in ordinary life, profitability is the test of whether something is worth doing or is being done efficiently. What profit is, in economic terms, is more debatable.

Here are some of the explanations that have been offered:

1. Marxists say profit is surplus value: that is, something stolen from the workers' pay envelopes. In a sense, and certainly in communist countries, this is correct. The leaders of the USSR and the People's Republic of China have to squeeze surplus value from the workers in order to accumulate capital for development and depreciation, as well as to pay the expenses of management and government. This is not called "profit"—indeed it is hardly mentioned—but it takes the form of hidden taxes, called, in the Soviet Union, the "turn-over tax," that is, a tax imposed every time the product is turned over to another stage of production or distribution. Obviously profit, in the market economy, goes to provide further capital and managerial expenses.

2. Some economists, therefore, argue that profit is, so to speak, the wages of the entrepreneur and the managerial, executive staff.

3. Others, in the nineteenth century, said

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profit was rent paid to the entrepreneur for his skill and his equipment.

4. Again, profit is sometimes regarded as interest (variable) on capital invested by entrepreneurs and stockholders in general.

5. Another explanation is that profit is recompense for risk-taking. Most businesses are subject to uncertainty. Costs may prove too high. The market may fluctuate. In the early phases of development, a business may make losses over a considerable period. Thus, the idea of profit cannot be understood without taking account of its reverse—the possibility or probability of loss.

On the whole, each of these explanations, including the Marxist one, has something to contribute to our understanding of profit. In a static economy, such as a primitive, communistic society, profit would have no part. In a growing or changing economy, profit has a major role. It provides the motive for saving, investing and innovating. It is a reward for skills, risk-taking, and capital. It is, finally, the measuring-stick of economic efficiency in a competitive system, and, consequently, a necessary device to provide society with the means of maximizing production and productivity.

No doubt profits have sometimes been or seemed to be excessive. But in the absence of monopoly, and in the presence of labor unions, this situation is unlikely to be a frequently occurring one. In any case, "excessive" is a relative term, and a profit that seemed excessive in a stable, established business might be normal and right in a high-risk business subject to fluctuations of public taste or striving to introduce a new product.

The student who fails to grasp these general principles might be asked to look at the working of state-planning in totalitarian systems or in democratic socialist systems, and to examine the ways in which such systems try to find a substitute for profit both as motive and measuring-stick. He may conclude, as two British economists did:

> that profit in the sense of a risk premium is likely to be present in any kind of economic system, whether based on private enterprise or on state ownership and planning. As long as there is uncertainty about output or the performance of labor, management or any other factor of production, state-planning has to take it into account in its decision-making. The only way in which it can abolish profit is by preventing change so that wants can be foreseen without uncertainty. [1]

PRICES AND PRICE-FIXING

In the past year or two demand-pull inflation has been rampant in the United States, and the Federal Government has twice resorted under political pressure to freezing prices temporarily. Many economists have pointed out that such measures at best are mere stop-gaps, and at worst make the process of economic adjustment slower and probably more painful. Price-fixing by government has been historically ineffective, except in certain unusual circumstances. In wartime, for example, prices can be held fixed up to a point; but in wartime the economy is run on totalitarian lines, that is, production for a specific object—winning the war—is planned centrally, and civilian consumption is rigidly controlled by rationing. Moreover, in wartime, consumers are usually willing to postpone consumption and refrain from black market activities.

The following paragraphs from an editorial in the Wall Street Journal are worth pondering.

> Though few people seem to have been let in on the secret, when supplies drop and demand increases, prices also increase. The government can pass laws to prevent this, which is much like outlawing the law of gravity. Except that laws against prices have more side-effects. When you freeze prices at levels that mean farmers can't produce meat without a loss, they are likely

[1] Arthur Seldon and F.G. Pennance, Everyman's Dictionary of Economics (London: J.M. Dent and Sons, 1969), p. 341.

to stop producing meat. This means there is less meat. This means prices go up.

Let's try it once more for the benefit of any lawmaker reading: When supplies drop, prices usually rise. Laws to hold down prices mean supplies are likely to drop, or at least not increase as much as they would have. Lower supplies mean higher prices. When production is held down, prices go up. [2]

TWO KINDS OF INFLATION

The term "demand-pull inflation," used in the preceding item, may call for explanation. Inflation is symptomized by rising prices, or (which is the same thing) the declining purchasing power of money.

Economists generally feel that in order to take steps to check inflation one must identify its character or causes. They have therefore established two categories of inflation: demand-pull and cost-push.

Demand-pull inflation is caused by excessive demand that outruns the supply of goods. Thus a boom period, in which incomes and the supply of money increase, but in which production does not increase proportionately, produces demand-pull inflation. The consumers, unconsciously, bid up the price of goods.

Demand-pull inflation may be started by government fiscal and monetary policies. When the government engages in deficit spending (paying for government expenses by borrowing rather than raising taxes) it encourages demand-pull inflation, because consumers and government are spending more than they produce. Thus the origins of the inflation of 1968-9 may be traced at least in part to the Johnson years when an expensive war and an ambitious social welfare program (the Great Society) were carried on without proportionate tax increases.

Cost-push inflation tends to follow demand-pull. Cost-push inflation results when production costs rise without a corresponding increase in efficiency of production. Between 1969 and 1971, labor in general gained large wage increases to compensate for the rising cost of living due to the preceding demand-pull phase. The example was set by Congress, which voted itself a 41 per cent salary raise early in 1969. Consequently, with increased labor costs, costs of production rose, and prices followed suit.

During this period the government (after a period of so-called "jaw-boning") tried the Keynesian and monetarist means of checking demand-pull inflation (income-surtax, tight money). However, prices did not decline (they continued to rise) and a recession occurred simultaneously. Government then reversed its policies (at the federal level though not at state and local levels), and a boom in 1972 set off, apparently, another phase of demand-pull. At this point, the federal government once again tried to hold down federal spending and to check the growth of the supply of money. By mid-1973, some economists were predicting another cost-push phase.

The above summary is oversimplified and wide open to critical objections, but it may serve to illustrate crudely the two kinds of inflation. It is perhaps unnecessary to apologize for the shortcomings of this account, since economists and government policy-makers seem to be baffled. One thing seems reasonably clear: neither the Keynesians' nor the monetarists' theories for regulating the economy are as effective as their exponents once claimed, and a more subtle system of diagnosis, prognosis and prescription for inflation and deflation may be in the offing.

THE CONCEPT OF MARGINAL UTILITY

Among terms that cause anxiety to teachers is the term "marginal utility," which is central to modern economic analysis. Yet the term is not really so forbidding, and the concept is invaluable in discussing matters ranging from the allocation of factors of production to consumer economics or ecological problems.

The word "marginal" refers to the unit of a commodity which is the "last" unit—

[2] Wall Street Journal, 16 July 1973, Section "Review and Outlook." The point was made more elaborately by economist Paul W. McCracken in an article "Controls, Inevitable—and Perilous," in the Wall Street Journal, 19 June 1973.

the one on the edge or margin. The theory of marginal utility attempts to explain the logic of economic choice, or the process which consumers and producers follow in maximizing satisfaction or maximizing efficiency.

The simplest illustration is provided by the case of an individual consumer. His resources are limited. He wants to use them rationally to maximize the satisfaction of his wants. One can break down his wants into categories: food, clothing, shelter, recreation, etc. These in turn can be divided into sub-categories, e.g.: meat, fruit, bread, milk, etc. Each category or sub-category can then be divided into convenient units. Thus, in a given month, the consumer decides how many units of meat he needs and can afford. The first 20 units of meat may be desirable and satisfying, but the 21st unit may be a mere luxury, and the 25th unit may be utterly unnecessary and wasteful. The 20th unit, then, is the marginal unit. So with his other wants: each successive unit after a certain point is less and less useful. He therefore, more or less consciously, distributes his resources (money) so as to obtain maximum satisfaction. In each category he cuts off his purchases at the marginal unit—the unit which has only marginal utility for him.

His decisions are, of course, governed also by the relative costs of the units of different commodities. If meat rises in price, he may decide that the marginal unit of meat will be number 12, and substitute other foods—fish, eggs, soybeans—which will provide the satisfaction he wants at the price he is willing to pay. Thus the consumer adjusts his expenditures according to the relative marginal utility of each commodity.

This logical process applies to all economic decisions. A manufacturer will decide whether to replace labor by machines in terms of the relative cost and efficiency of the marginal unit of labor compared to the cost and efficiency of the marginal unit of capital equipment. When labor costs reach a certain point, further automation may be dictated by the principle of marginal utility. On the other hand, a business which spends too much on machinery as compared with labor, through miscalculating the marginal utility of each factor, may price its goods out of the market.

A final illustration may be taken from the topical subject of pollution and conservation. Consider the case of a community faced with air and water pollution. The cost of each unit of electricity, for example, will be enhanced by every antipollution device installed. What sacrifices will the people of the community be prepared to make? What is the marginal utility of all the conveniences of cheap electricity compared with the marginal utility of clean air and water? Is the marginal utility of home airconditioning greater or less than the marginal utility of less smog in the air or a lake free from thermal pollution? How much electricity at what price can be traded off against a how much pleasanter environment? It is, economically speaking, a matter for marginal analysis.

Innumerable examples of the practical application of the concept could be given. The concept is especially useful in the classroom as a device for bringing vague general discussions down to realistic terms of competing priorities and relative costs. Economic standards are not, of course, the only standards to use in decision-making, but they are highly important. To neglect the principle of marginal utility is to open the way to absurd, impossible and utopian decisions.

INDIFFERENCE ANALYSIS

Economists today often prefer to speak of ordinal utility or indifference analysis rather than the law of diminishing marginal utility, when analyzing consumer preference. See the articles on these topics in Bannock, Baxter and Rees, The Penguin Dictionary of Economics (Harmondsworth, England: Penguin Books, 1972). Teachers will find this booklet most valuable.